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**It appears to me that one great cause of our difference in opinion on the subjects which we have so often discussed is that you have always in your mind the immediate and temporary effects of particular changes, whereas I put these immediate and temporary effects quite aside and fix my whole attention on the permanent state of things which will result from them.**

**— A letter from David Ricardo to Robert Malthus, 1817**

## APOCALYPSE LATER

Despite all the worried talk about the sliding dollar, both the financial markets and economic forecasters are taking it in stride. Conspicuously, nobody speaks of a dollar crisis at present or in the future. High-riding expectations of a strong year-end rally in the stock markets have been somewhat disappointed. Yet there have been two pleasant major surprises. One is the sharp fall of oil prices, and the other is the resilience of the U.S. bond market, defying not only the dollar's weakness, but also the four rate hikes by the Federal Reserve.

It appears to be a common view that economic growth in the eurozone and Japan is badly faltering again, with both countries flirting with new recessions. In contrast, the forecasts for the U.S. economy remain rather upbeat, hailing the plunges in oil prices and the dollar.

We stick to our diametrically opposite view that the U.S. economy is prone to sharply slower growth. It is the profligate consumer who has kept the economy afloat since 2000. What kept the consumer afloat is also no secret. It was mainly two events: *first*, inordinate tax cuts; and *second*, exploding ultra-cheap borrowing facilities, made available through the Fed's creative bubble strategy and implemented by ultra-low short-term interest rates.

Together, the two have unquestionably contained the fallout from the bursting stock market bubble. They also had respectable effects in terms of U.S. real GDP growth during the second half of 2003 and the first half of 2004. Yet the most important aim of all the monetary and fiscal stimulus — to set in motion a self-sustaining economic recovery — has been flatly missed.

A "self-sustaining" U.S. economic recovery urgently needs accelerating employment and income growth. Just the opposite is happening. During the six months up to last November, real disposable personal income grew just 1%, or 2% annualized. This is down from 3% in the first half of 2004 and 4.8% in the second half of 2003. Taxes and higher inflation rates are taking their toll. Debt-financed spending went to new records. During the third quarter, private households increased their spending by $139.4 billion, while their earnings increased only $81.6 billion.

Employment and income growth are the key fundamentals of household finance. According to the reports of the Bureau of Labor Statistics (BLS), they have significantly improved in 2004. But no less than two-thirds of these gains owe their creation to the ominous "net birth/death" computer model of the BLS, designed to estimate employment growth by new business formations.

All that is needed to activate this job creation is a unilateral decision by the BLS that the U.S. economy is in a recovery. Implicitly, the Bureau of Economic Analysis translates these computer-generated additions to employment into corresponding additions to wages and salaries. Considering the persistent, unusual weakness in employment, as documented by the actual surveys, it requires a lot of heroism to assume an employment boom from new business formations.

For November, the BLS reported 112,000 new jobs, as against an expected 200,000. As bad as the report appeared, the reality was even worse. No less than 54,000 of the new jobs had come from the net birth/death computer model, compared to 30,000 jobs in November last year.

In the third quarter of 2004, consumer spending accounted for 89.2% of real GDP. It is the familiar ruinous growth pattern. A viable economic recovery would require a strong contribution through sharply higher business investment and hiring. Both remain missing, although the recovery is entering its fourth year.

## EUROLAND'S SECRET SUCCESS STORY

*"The United States is richer and grows faster than euroland because productivity levels are higher and productivity growth stronger — right? Actually, no. Euroland's inferior GDP performance is attributable to a slower-growing labor force that works shorter hours.*

*"Euroland's underlying economic performance is better than many commentators portray. Over the past decade, GDP per head has risen virtually at the same rate in euroland as the United States; euroland productivity growth (output per hour) and the rise in the employment rates were slightly faster than in the United States; and to maintain the same growth in GDP per head, U.S. workers have had to work much longer hours than their euroland counterparts."*

This subtitle and the above two paragraphs are not ours. They are the introductory remarks to a study about the eurozone economy, written by Kevin Daly and published by Goldman Sachs in January 2004.

Gloomy reports about the eurozone economy always abound. To quote a leading article that appeared in the *Financial Times* under the headline "Two Broken Motors": *"The latest economic data leave the eurozone and Japan looking more than ever like two enfeebled old men unable to progress at more than a stagger."*

With utter amazement, at the same time, we keep reading that the U.S. expansion remains firmly on track, particularly with sharply improving jobs data. Third-quarter real GDP growth was revised upward to 4% at annual rate, compared with an annualized growth rate of 1.2% for the eurozone. Since the end of 2000, America's output, as measured by real GDP, has grown more than twice as fast as the euro areas.

Quoting the London *Economist*: *"Euro-pessimists see this as further evidence that arthritic economies are being held back by lazy workers and by governments unwilling or unable to carry out reforms. In contrast, America's more robust recovery, it is often said, reflects its amazing flexibility."*

In our view, in contrast, the U.S. economy's recovery since 2001 peaked in the first quarter of 2004. This assumption is primarily based on four observations: *First*, it is the overwhelming message of recent economic data and early indicators; *second*, the power of egregious fiscal and monetary stimulus has been spent; *third*, continuous rate hikes by the Fed will prick both the carry trade and the housing bubbles; and *fourth*, the U.S. economic recovery is of a flatly unsustainable pattern.

To prevent a more painful fallout from the bursting equity bubble in 2000–01, Fed Chairman Alan Greenspan systematically blew three intertwined new credit bubbles: the carry trade bubble in bonds, house price inflation and the mortgage refinancing bubble.

It was the policy of a desperado who did not care at all about adverse consequences in the longer run. In actual fact, the very imbalances that provoked the preceding recession have grossly worsened under the impact of the new asset and credit bubbles.

## THE GROSS POLICY FAILURE

With these considerations in mind, the persistently bullish forecasts for the U.S. economy utterly astound us. They should not, really. It is a well-established fact that recessions have always taken American economists

completely by surprise. The most recent and also most flagrant case in point is, of course, the downturn of 2000–01. The consensus never saw anything wrong in the economy before business capital investment plummeted like a bolt from the blue. Neither did the Fed see anything wrong.

How do we recognize whether given economic policies are successes or failures? The general perception holds that the U.S. policies since 2000 have been a great success. The measure for this favorable assessment is the far lower economic growth rates of the world's two lame ducks, Europe and Japan. In our view, it is an unfair, unreasonable and highly deceptive comparison.

In the United States, the swing in the government's budget from surplus into deficit over the four years since 2000 was equal to about 6–7% of GDP. In the eurozone, the overall government deficit, measured as a share of GDP, is no higher today than in 2000. As to monetary policy, the European Central Bank reduced its interest rate by 2.25 percentage points, to 2%, while the Federal Reserve slashed its interest rate by 5.5 percentage points, to 1%. Most important, money and credit growth in the United States is a multiple of that in the eurozone.

Ultra-low — in fact, negative — real short-term rates in the United States fueled rampant inflation across all assets, thus providing soaring collateral for equally eager borrowers and lenders. This combination propelled the greatest credit excesses in history, while personal and national saving collapsed. Also important, the credit deluge poured overwhelmingly into financing consumption and financial speculation.

Over the four years since 2000, the U.S. economy overall has posted a little more than 10% real GDP growth. This compares with the miserable 4% growth of the eurozone. By this comparison, the U.S. performance appears a smashing success. Compared with prior postwar recoveries in the United States, however, it was by far the weakest recovery of all.

As to this unfavorable comparison between the United States and Europe, in the first place we find fault with the underlying inflation rates. As is common knowledge, the BLS has been most creative in the past few years in lowering its calculated inflation rates on account of quality improvements (infamous as "hedonic pricing") and so-called substitution effects.

An advisory commission of the Conference Board, with Paul McCracken and James Tobin as members, estimated that the overall downward correction of the U.S. consumer price index amounts to 1.5 percentage points, essentially repeating itself every year.

The important thing to see is that the United States is alone in the world with these methods of calculating inflation rates and — more importantly — that this implicitly understates them in comparison with other countries. Being deducted from the nominal GDP numbers, lower inflation rates implicitly increase U.S. real GDP and productivity growth. In other words, the U.S. economy's stellar growth performance in real terms owes a lot, if not everything, to this peculiar calculation of its inflation rates.

In short, the U.S. real GDP numbers of recent years have to be taken with a substantial grain of salt. For us, the economic truth is in the dismal employment figures. Even with an extraordinary 1.1 million increase in public employment, total employment is back only to the level of 2000. This compares absurdly with the reported real GDP growth of 10% during this period. In past postwar economic recoveries, the private sector had created an average of 6 million additional jobs by this time.

***By the employment gauge, the U.S. economy is plainly experiencing its worst recession in the whole postwar period. For us, it is the performance measure to focus on.***

In the same vein, we keep focusing on the development of the U.S. economy's often-cited economic and financial imbalances: Since 2000, the reported national savings rate has fallen from 5.9% of GDP to minus 0.3% in the third quarter of 2004; the federal budget has swung from a surplus of $189.5 billion to a deficit of $444.9 billion at annual rate in the second quarter of 2004; and the current account deficit has soared from $413.4 billion to $664.8 billion at

annual rate. Ludicrously, the big saver in the economy is the business sector, investing far below its earnings.

## THE WORST EMPLOYMENT PERFORMANCE IN THE WORLD

Few people seem to realize that the U.S. economy's employment performance since 2000 is the worst in the world. Asia is, of course, booming. The biggest surprise, however, has happened in Europe. From 2000 through the end of 2003, the number of employed people in the European Union increased by 4.1 million, compared with an increase of 1.5 million in the United States, according to a report recently released by the European Commission.

The report, *Employment in Europe 2004*, is the commission's comprehensive annual analysis of labor statistics. It does not include the 10 new members from Eastern Europe.

The increase in employment in Europe was made possible, the report says, by bringing more women into the work force, by creating more part-time jobs and by lowering social charges in some countries. In the United States, the share of working-age people with a job fell to 71.2% at the end of 2003, from 74.1% in 2000. In the European Union, the share increased to 64.8% during the period, from 63.6%. The strongest employment growth in Europe was in the service sector, mainly real estate, transportation, hotels and restaurants.

## MIRROR, MIRROR ON THE WALL

Back to the question of Europe's economic performance. For many years, the U.S. economy has enjoyed the admiration of the whole world as the global star performer, while the economies in Europe are discarded as inefficient and sclerotic. European managers and investors, forever fretting about their own shortcomings, fell over themselves to invest hundreds of billions of dollars into the American profit and productivity miracle, as trumpeted by Greenspan and Wall Street. Many of them lost their shirts.

Meanwhile, we have been waiting for some institution in Europe to rectify this grossly distorted perception — in vain. Yet there were various critical studies from American and British writers. One of them is the already mentioned Goldman Sachs report from Kevin Daly. We also particularly appreciated a special report, "Mirror, Mirror on the Wall — Europe v. America" by the London *Economist* (June 19, 2004), which explains in detail the major differences in calculating productivity and GDP growth. The above subtitle is, in fact, borrowed from that report.

In America, the commonly used measure for productivity growth is output per hour in the nonfarm business sector. Implicitly, this excludes the notoriously unproductive public sector. In Europe, the measure is output per worker in the whole economy, including the large public sector. Implicitly, there is no adjustment for the rapid growth in part-time jobs during recent years.

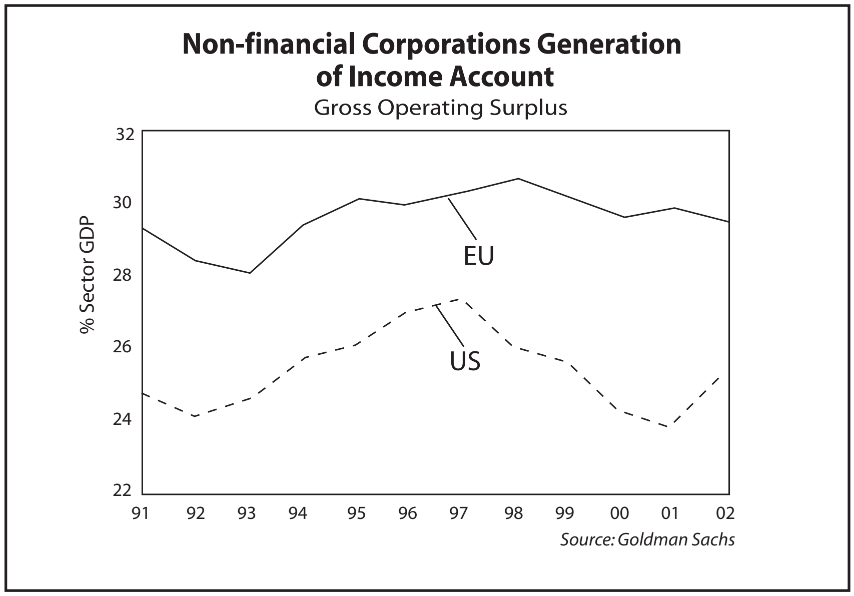
Using GDP per hour worked across the whole economy, American productivity growth has risen by an annual average of 2% since 1994, a bit faster than the euro area's 1.7% growth rate. Daly's study finds that, after adjusting for differences in their economic cycles, trend productivity growth in the euro area has been slightly faster than America's over the past 10 years. To quote from *The Economist*: *"Since 1996, productivity growth in the euro area has been slower than America's. But it seems fairer to take a full 10 years."*

***The gist of both reports is that euroland's inferior GDP performance is attributable to a slower growing labor force that works shorter hours. It has virtually nothing to do with differences in productivity growth.***

Yet both reports do not address a question uppermost in our mind. That is the existing differences in measuring inflation rates implicitly translating nominal GDP growth into real GDP growth. Taking into account the major difference in measuring the inflation rates, as described, in addition to the differences in measuring productivity growth, essentially leads to the conclusion that euroland has the higher rate of productivity growth. Given its high wage levels, it is really a compelling conclusion. In his report, Daly has a chart with the title: *"U.S. productivity growth has accelerated, but only to rates that euroland commonly achieves."*

Discussing the implications for the financial markets, Daly dismisses the idea, as suggested in the original Lisbon agenda, that Europe should strive for "U.S.-style growth.": *"In many areas, where policy can have a meaningful impact — raising productivity and employment — euroland's underlying performance is already on a par with the United States'...*

*"For financial markets, the key insight is that slower euroland GDP growth driven by weaker labor force growth should not result in a lower rate of return on euroland assets… The U.S. economy will continue to grow faster than euroland over the next 10 years because growth in labor supply will substantially outstrip that of euroland. But as long as faster growth is driven by demographics alone, this is not a reason to expect greater future returns."*




## THE ACID TEST OF HEALTHY OR UNHEALTHY GROWTH

For many years, it has been conventional wisdom that Europe urgently needs structural reforms to catch up with America's stellar growth performance. What this precisely means is generally left rather vague, yet its urgent need is clear. For many people, it essentially means that European managers ought to join their American counterparts in readily hiring and firing workers.

We doubt that most of them will. Moreover, we have never believed that this device explains the U.S. economy's better employment performance in the past. Manifestly, it has not helped America in the past. Yet more flexibility in this regard is certainly desirable for Europe. Its surprisingly strong employment growth during the past few years certainly owes a good bit to actual liberalizing measures.

In terms of real GDP growth, the U.S. economy has plainly outperformed the European economies in the past few years. As explained, we regard this measure, first of all, as badly flawed. Assuming that U.S. inflation rates are understated compared to those in Europe by no more than 1% per year, America's lead in GDP growth already melts to insignificance. In our view, the understatement is bigger.

Still, the understatement of U.S. inflation rates is not the only reason for our misgivings about the U.S. economy's performance. We regard its pattern of growth as utterly unhealthy, and therefore unsustainable. The acid test of healthy or unhealthy economic growth, from a long-term perspective, is changes in the allocation of resources between consumption and investment.

***The following remark by John Maynard Keynes used to be a truism among economists, Americans included:*** **"It is investment, i.e. the increased production of material wealth in the shape of capital goods, which alone increases national wealth."** ***Putting it more precisely: which alone increases national wealth in the present and the future.***

In an interview with the *Financial Times*, Jean-Philippe Cotis, chief economist of the Organization for Economic Cooperation and Development in Paris, recently stated that countries running persistent budget deficits are sacrificing their children by *"bequeathing them a capital stock which will be grossly undersized."*

He failed to mention that personal dissaving has just the same evil effect on capital stock. In the last letter, we

called it “generational irresponsibility” when parents bequeath their children a shrinking capital stock and a mountain of foreign debts. The key reason why we are richer than our ancestors is that these ancestors have bequeathed us buildings, factories and machines that have given us a high living standard to start with. Driven by irresponsible policymakers, America’s present generation is consuming the nation’s capital.

## DRIVING IMBALANCES TO NEW EXTREMES

It should be clear that what crucially matters for the sustainability of an economic recovery is, above all, its underlying quality, meaning changes in allocation of resources between consumption and productive investment.

It was manifestly not credit tightness that aborted the U.S. economic boom in 2000 and also the stock market bubble in the following year. As credit has kept expanding at record pace, it is a compelling conclusion that forces other than tight credit have essentially broken the boom.

For the old economists, it was a truism that a boom can abort even with loose money and credit if credit excesses disrupt the economy’s established pattern of consumption, saving and investment. In the past few years the United States has “enjoyed” credit excesses of a size that defies the imagination of any reasonable person.

What is the U.S. economy’s established consumption-saving-investment pattern? With some grains of salt, one may say that consumer spending has normally accounted for about two-thirds of GDP growth, with 6–10% of disposable income being put into savings. The contribution of gross business fixed investment used to fluctuate around 14% of GDP and government spending around 20%. Until the early 1980s, exports slightly exceeded imports.

These proportions changed drastically during the boom years 1995–2000, as soaring stock prices induced the consumer to boost his spending at the expense of his saving from current income. Consumption increased markedly as a share of GDP, while the trade balance soared into deficit.

Since 2000, though, there has followed a drastic change in the composition of GDP, starting with an abrupt slump in business fixed investment. Trying to contain the damage to the economy, the Fed responded with the most rapid and radical easing of its monetary reins, while the government opened its fiscal spigots with drastic tax cuts and higher spending.

## A CURE THAT IS WORSE THAN THE DISEASE

Greenspan likes to boast of having managed the mildest postwar recession in the United States. What he and most American economists flatly ignore is that this cure has dramatically changed the composition of the GDP growth to a totally unsustainable pattern.

Two numbers say it all: Bubble-driven consumer spending accounted during the three years 2001–03 for 109.2% of real GDP growth and government spending for another 33.3%.

Still more shocking are further details: From 2000–2003, U.S. real GDP grew altogether by 5.75%. But its components changed at vastly different rates: consumption, up 9.14%; therein, consumer durables, up 19.38%; nonresidential fixed investment, down 9.84%; residential investment, up 14.39%; exports, down 5.89%; imports, up 5.05%; and government spending, up 10.1%.

Judging the U.S. economy’s viability requires a close look at these major changes in its pattern. What they reveal is a structural disaster: Debt-driven consumer spending has soared at the expense of saving, nonresidential investment and exports. To hail this as a successful policy is preposterous.

It was unquestionable for American policymakers and the consensus that a burst of consumer and government spending would be bound to stimulate strong business investment. According to the logics of Austrian theory, heavy deficit spending by the government and the consumer must have the opposite effect of crowding out business investment and exports.

Greenspan and Wall Street pundits like to explain the U.S. economy's apparently superior past growth performance — as gauged by real GDP — with extraordinary dynamism, flexibility and resilience on the economy's part. We find these qualities much too vague. The definite flexibilities that we see are a soaring trade deficit, a savings and investment collapse, a ballooning budget deficit and skyrocketing consumer debts, as well as a generally flat refusal to rectify them.

For anybody with a little critical sense, it ought to be plainly obvious by now what the true secret of the U.S. economy's "extraordinary resilience" is — boundless borrowing for consumption, government spending and financial speculation, with destructive effects on saving and investment.

## SLAUGHTERING U.S. MANUFACTURING

Loose money and credit generally work in the short run. But there always comes a point at which its growth effects exhaust themselves of their own accord. The single most spectacular and, in our view, decisive influence in depressing U.S. economic growth in the long run is the ravaging of the manufacturing sector through the soaring trade deficit.

***As a rule, central banks fight the economic and financial maladjustments from boom-related credit excess with tight money. The Greenspan Fed has been fighting the fallout from the credit excesses of the late 1990s with still more credit excess. The implicit result was that the structural maladjustments that existed in 2000 were driven to new extremes.***

What actually happened perfectly confirms to the Austrian view. In 1995–2000, the real-cost net stock of nonresidential fixed investment had grown at an annual average rate of 3.2%, most of it in information and processing equipment and software.

For a booming economy, this was already very much on the low side. During the following three years, 2001–03, though, the growth of this part of the capital stock slumped to 1% per year. For manufacturing, it edged up during those three years by a dismal 1.8%, or 0.6% per year. Residential investment, in contrast, grew 2.9% per year.

Now, let us do a little instructive calculation concerning the question of whether the falling dollar may substantially rectify the U.S. trade imbalance. It starts with the recognition that the U.S. trade deficit is largely an imbalance in the foreign trade of manufactured goods.

As pointed out, consumer spending rose over the three years 2001–03 by 9.14% and government spending by 10.1%. Now to the supply side of the equation, as also detailed above: manufacturing capital stock up 1.8% over the same three years and manufacturing employment down a savage 3 million, or almost 20%.

***These numbers suffice to draw a compelling conclusion: The monstrous U.S. trade deficit is neither a dollar problem nor a cyclical problem. It is overwhelmingly a structural problem. It has two obvious root causes: protracted creation of excessive domestic demand for consumption versus abysmal savings and net new investment on the supply side.***

## WHO NEEDS RESTRUCTURING MOST OF ALL?

Looking at the United States and Europe, we keep asking ourselves which economy needs drastic restructuring most of all. Our categorical answer is the U.S. economy, with its egregious, destructive trade deficit.

This protracted, drastic shift in the U.S. economy's demand pattern has essentially invoked a commensurate drastic shift in the use of available resources. Dollar devaluation, clearly, does very little or nothing at all to rectify this detrimental resource shift in the economy away from investment toward consumption.

The reversal of this destructive trend first requires a consumer who significantly restrains his borrowing and

spending excess. Actually, we think that the unfolding sharp slowdown in disposable income and the fading, if not bursting, of the housing-refinancing bubble will force him to retrench in due time. This is inescapable and will be the great surprise of 2005. If the Fed continues its rate hikes, this will, of course, also help.

## MANY TYPES OF INFLATION

In the past few years, the United States has experienced unprecedented credit excess relative to GDP and available savings. In terms of credit growth, it is the greatest inflation orgy in history, massively affecting the whole world. Inevitably, it has caused tremendous distortions in both the U.S. economy and its price system.

Our focus is primarily on the structural changes in the economy, as emphasized by Austrian theory. They determine economic growth in the long run. But credit excesses of such tremendous size essentially also provoke gross distortions in the national price system. For good reasons, readers want an idea of what the overriding risk is for the U.S. and the world economies in this respect — inflation or deflation.

Answering this question, we have to start with some general considerations. Most people, in the United States in particular, identify inflation as a sustained, substantial rise in the prices of consumer goods and services. Among economists in Europe, in contrast, it has always been more customary to define inflation as consisting of excessive money or credit creation, focusing thereby primarily on the cause of rising prices.

It is, in fact, necessary to distinguish between the cause and the effects of inflation. As to its cause, there is principally but a single one: excessive money and credit creation. But depending on circumstances, there may be very different effects according to the point at which the additional money first enters the economy or its financial system.

***In consequence, an excessive credit expansion may express itself in many different ways: rising consumer or producer prices, rising asset prices, a rising trade deficit and also in distortions and dislocations in the economy's demand and output structure.***

Measured by its protracted runaway money and credit growth, the United States has "enjoyed" one of the worst inflations in history. But contrary to traditional experience, the inflation of the last few years has overwhelmingly gone into asset prices — that is, the prices of stocks, houses and bonds — and into the soaring trade deficit.

Policymakers and most economists in the United States flatly fail or refuse to see the straight causal connection between the two expressions of inflation and the credit excess. Rather, they hail the hyperinflation in asset prices as a marvel of rapid wealth creation and the trade gap as the emblem of superior U.S. economic growth. As to the destructive effects of these two unusual manifestations of inflation, complete blindness rules.

The one and only inflation that U.S. policymakers and most economists recognize as such is in rising consumer and producer prices. Increasing at a "modest" annual rate of 2–3%, this constitutes to them virtual price stability.

For years, it has been boasted that the coincidence of strong economic growth with low inflation rates is a hallmark of the U.S. economy's new extraordinary virility. It did not occur to policymakers and economists that this "miracle of price stability" owed its existence to the exploding trade deficit by diverting the inflationary borrowing and spending excesses of the consumer away from the domestic price system and toward surging imports.

If the United States were a closed economy, this would, instead, have translated into soaring inflation rates, with soaring interest rates in its wake, aborting the recovery long ago. A rising trade deficit and rising prices of goods and services are simply alternative manifestations of one and the same underlying cause: excess domestic demand. The point to see is that U.S. goods inflation is heavily suppressed by the soaring goods imports.

## PARASITIC "WEALTH CREATION"

In contrast, the inflation raging in the U.S. asset markets has been unfolding in full force. Moreover, the Asian

trading partners, eager to boost their exports, even actively assist it with the large-scale purchases of U.S. bonds they undertake to prevent a rise of their currencies.

It appears that policymakers and economists regard lower inflation and interest rates as desirable blessings of foreign trade for America. That the United States pays for these blessings with sharply lower capital formation in general and the massacre of its manufacturing sector in particular is beyond their understanding.

Artificially low inflation and interest rates are never a blessing, because the latter infallibly fosters credit and debt excess. In the United States, the result has been protracted preposterous credit excess. During the three years 2001–03, on which we are focusing, nonfinancial credit ballooned by $4.2 trillion and financial credit by another $1.9 trillion, together $6.1 trillion.

Obviously, the most dangerous component in the debt deluge is exploding consumer debts. During those three years, they soared by $2.4 trillion, or 34%, while consumer disposable incomes increased by $965 billion, or 13%.

For Greenspan and the consensus, this rampant debt creation is no problem, because it is more than offset by far bigger "wealth creation" through rising asset prices. We have to say that we rigorously object to ranking rising asset prices as wealth creation. True wealth creation has two indispensable components: rising value and rising income. Manifestly, the most important income component is flatly missing in this kind of wealth creation.

***Our second vehement objection arises from two further considerations:* First*, this so-called wealth creation has its quack origin in loose money and artificially low interest rates; and* second*, it boosts consumption at the expense of saving and investment. Strictly speaking, this is the exact opposite of wealth creation — impoverishment.***

In 1996, an article entitled "Securities: The New World Wealth Machine" appeared in *Foreign Policy*. The author stated, *"Securitization has become the most powerful engine of wealth creation in today's world economy."* While societies used to only accumulate wealth slowly through creating tangible assets, they can now do so quickly and directly, and *"the new approach requires that the state finds ways to increase the market value of its productive assets."* In such a strategy*, "an economic policy that aims to achieve growth by wealth creation therefore does not attempt to increase the production of goods and services, except as a secondary objective."*

When we first read this elaborate explanation long ago, we thought this man was insane or joking. But is this not precisely the American economic reality of today? In days of yore, rising asset values were viewed as a byproduct of improving economic fundamentals. Now it is the other way around. Asset prices drive the economy.

Blowing asset bubbles through slashing and manipulating interest rates to rock-bottom lows — with the explicit aim to boost consumer borrowing and spending through rising U.S. asset prices — has been the Fed's strategy since 2001. It was the policy of desperados who saw no alternative.

For us, it is ludicrous to hail any asset bubble as "wealth creation." From the macro perspective, it is the exact opposite — capital consumption. Here we come to the essence of what David Ricardo wrote to Robert Malthus in 1817 — that is, the crucial difference between *"immediate and temporary effects and the permanent state of things which result from particular changes."*

Of course, the bubble-driven consumer borrowing-and-spending binge has helped to generate higher GDP growth. But by pulling a growing share of available resources into consumption at the expense of saving, investment and the trade balance, this has badly impaired future economic growth.

Putting it bluntly, parents have two macroeconomic tricks to raise their living standard at the expense of their children: bequeathing them a shrinking capital stock and a mountain of foreign debts. That is why we have labeled this wealth creation through asset bubbles as "parasitic." In essence, parents convert the "family silver" into consumption.

***It has to be realized that the future living standard of both the working population and retired people will***

***depend on what the working part of the population produces at that time. But how much they are able to produce depends crucially on how much their parents have saved and invested for the future.***

Frankly speaking, this persistent babble in America about rampant wealth creation through asset bubbles has infuriated us for a long time. It is not only irresponsible; it is also utterly stupid. In the third quarter of 2004, consumer spending accounted for 89.2% of real GDP. It is the familiar ruinous growth pattern. A viable economic recovery would require a strong contribution through sharply higher business investment and hiring. Both remain missing, although the recovery is entering its fourth year. Where is the gain even for the individual house owner, who at some time in the future will sell his house at an inflated price in order to buy another one at an equally inflated price?

## HOW WILL THIS INFLATION ORGY END?

As a matter of fact, we are sure there will be no chance to sell stocks, houses or bonds in the future above or even at the present inflated prices. As explained, these prices are manifestly not based on a high level of saving; they are a temporary artifact of artificially low interest rates and a credit explosion. The obvious true name of this game is asset inflation, systematically and recklessly engineered by the Greenspan Fed.

Earlier, we explained that the United States has two very different kinds of inflation: moderate consumer and producer price inflation being suppressed by soaring imports, and unbridled runaway asset price inflation engulfing bonds, stocks, housing and the dollar, driven by rampant credit excess.

Now, the easiest thing to see is that all these credit-driven asset bubbles are sure to go bust. For us, their crash is a mere question of time — actually, of relatively short time. Let us say sometime next year.

Assessing the U.S. economy, we distinguish between this ugly reality and the prevailing highly bullish perception. The ugly reality that we see is phony wealth creation seducing private households into unprecedented borrowing and spending excesses.

On Dec. 15, the London *Financial Times* carried a brief leading article enthusiastically stressing that *"with every passing quarter, evidence mounts that the 'miracle' of higher productivity growth was genuine… and is likely to be a feature of U.S. economic performance for years to come."* The *Financial Times* refers to a new study published by the New York Federal Reserve, culminating in this assertion.

There was a time, in the 1980s, when we had high respect for the studies of New York's Federal Reserve. We fully understand why the bullish consensus repeatedly emphasizes the productivity miracle as the foundation of the U.S. economy's superior performance. After all, it is the economy's only positive feature.

But productivity growth is a mere statistical aggregate. A productivity miracle, as in the United States, that persistently fails to translate into accelerating income or profit growth is a statistical hoax. To make one thing absolutely clear, what is driving the U.S. economy has nothing to do with productivity growth. It has one single overwhelming cause — the frenzied consumer borrowing-and-spending binge. It alone stands between economic growth and relapse into recession in the United States.

## THE PARADOX OF OVERCONFIDENCE

It is generally argued that the dollar's accelerated fall arises from pessimism about the soaring U.S. trade deficit. We would say that the rising deficit as such is sufficient reason. As to the role of pessimism, we read and hear nothing but highly bullish forecasts for both the U.S. economy and its asset market, contrasting with pretty pessimistic forecasts for the eurozone.

It is widely assumed that rising stock and house prices will keep the American consumer both willing and able to keep the U.S. economy on track for strong growth. Never mind that this tends to boost the trade deficit. Very few have realized that this pattern of growth — with its evil effects on saving, investment, trade balance, and internal and external debt levels — is relentlessly corroding the economy's stability and viability.

To be sure, the bulging U.S. current account deficit and the falling dollar are posing the greatest and the most acute risks to the U.S. economy and its financial markets. So far its decline has been orderly. Continuous large dollar purchases by some Asian central banks are, of course, one reason. But an even more important reason seems to be the widespread hope that the falling dollar will go a long way to bring down the trade deficit and spur economic growth from the trade side.

For sure, Americans possess an extraordinary propensity towards optimism. But that is, of course, what policymakers, Wall Street pundits and headlines in the media are permanently hammering into their heads. Still, there can be too much of a good thing. Call it the paradox of overconfidence. Confidence is good, but overconfidence or false confidence has been the key cause of every severe economic and financial crisis.

## THE KEY DIFFERENCE — SAVING

In the consensus view, the U.S. economy is deriving its apparent superior growth performance from greater dynamism, flexibility or efficiency. Strict analysis convinced us long ago that the key macroeconomic discrepancy between the U.S. economy and that of the eurozone lies, in reality, in an immense difference in the savings out of current income.

Euroland puts a higher proportion of GDP into fixed investment than the United States. That is definitely positive. But much higher savings depress consumption. In various countries, Germany and France, for example, private households save around 11% of their disposable income, as against close to zero savings in the United States. While saving and investment have declined as a ratio of GDP in euroland, a large savings surplus persists, as reflected in an export surplus and weak consumer spending.

In the United States, in contrast, investment exceeds available savings, but only because personal and national saving has virtually plunged out of existence. More to the point, consumption has shot up as a share of GDP at the expense of investment and the trade balance.

Capital is created when production exceeds consumption; capital is destroyed when consumption exceeds production. For years America has been indulging in the latter. It beats the world in only two things: consumption and leveraging its asset prices. That, too, creates economic growth, but it is unsustainable, sickly growth. In essence, the Greenspan Fed has turned the U.S. economy into a bubble economy, mainly driven by three asset bubbles: bonds, stocks and private housing.

The frightening thing to realize is that in an economy without savings, asset price levels implicitly depend on credit creation through carry trade — that is, on unlimited borrowing at cheap short-term rates.

## THE REVERSAL

In the early 1990s, the Bank of Japan popped its bubble economy with a series of drastic rate hikes. The U.S. Federal Reserve has been lifting its federal funds rate at a "measured pace," from 1% up to 2.25% so far. Yet this gradually but surely flattens the yield curve, on which the carry trade of bonds depends. It has to rank as the biggest financial markets surprise of 2004 that long-term rates nevertheless fell from their earlier highs during the year. Of course, this has helped both the stock bubble and the housing bubble. Credit is cheap and abundantly available.

The only somewhat reasonable explanation we have is that hopes are running high for a "soft landing" of the U.S. economy and its currency. Strikingly, comments about the implications of the dollar's drop are in general biased toward emphasizing the negative effects for Europe and the positive effects for the U.S. economy: Above all, rising exports will overcome any slowdown of consumer spending and invigorate business hiring and investment. Inflation is the bogeyman that does not appear thanks to persistent global deflationary pressures.

Lacking dollar devaluation against China's currency is, of course, the first caveat. The most important caveat, however, derives from a delinquency originating in the U.S. economy itself: Protracted, gross neglect of

manufacturing investment has sharply curtailed the U.S. economy's industrial base. Remember that a trade balance is largely an imbalance in the trade of manufactured goods.

It has been calculated that the U.S. manufacturing base, as measured by jobs and incomes, is about 40% smaller today than it was in the mid-1980s, when the United States also embraced a conscious policy of dollar devaluation. At the today time, in fact, it unleashed an export boom, which sharply reduced the trade deficit.

The sheer monumental size of the U.S. trade deficit poses another daunting problem. With imports currently 53% larger than exports, any significant reduction of the deficit requires a virtually impossible export boom. Bluntly put, the U.S. economic and financial imbalances have become much too big to allow for a smooth adjustment.

Last but not least, there is the formerly famous J-curve effect to be taken into account. Based on past experience, it says that a currency has to be falling for at least 15 months before the positive volume effects of a currency depreciation begin to overtake its negative price effects. How will the U.S. bond and stock market react to a continuous deterioration of the U.S. trade balance? How will foreign investors react?

## CONCLUSIONS

Credit growth in the United States has gone completely insane. Since 2000, there has been $10.40 in additional debt for each dollar added to GDP at current prices. This is sheer Ponzi financing — and like all Ponzi schemes, someone will end up holding the bag. At the same time, the diversion of credit into bonds, stocks and housing has created an illusion of bulging wealth.

The most important thing to see about the U.S. economy is that the massive monetary and fiscal stimulus of the past few years has lamentably failed to restore a self-sustaining pattern of economic growth.

A falling dollar will put upward pressure on U.S. consumer and producer prices through rising import prices. Consequently, the Fed will be under pressure to raise interest rates even further than is generally expected.

Imploding asset bubbles will pull the rug out from under consumption. Investment will most probably follow suit. An export boom would be necessary to avoid a severe recession in the United States. But two arguments speak against this possibility: *first*, sharply slower global growth; and *second*, lack of U.S. export capacity.

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